

**Taxpayers Were Assessed Additional Tax
for Advance Earned Income Credit Payments
Not Received**

June 2003

Reference Number: 2003-40-126

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

June 17, 2003

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Taxpayers Were Assessed Additional Tax
for Advance Earned Income Credit Payments Not Received
(Audit # 200340028)

This report presents the results of our review to determine if the Internal Revenue Service (IRS) had reasonable assurance during tax return processing that the Advance Earned Income Credit (AEIC) payments reported by taxpayers were correct.

The Congress established the AEIC in 1978¹ to allow employees who are eligible for the Earned Income Tax Credit² (EITC) to receive a portion of that credit in advance with their pay during the year. During Tax Year (TY) 2001, employees could receive up to \$1,457³ in advance. Employees who choose to receive the AEIC file an Earned Income Credit Advance Payment Certificate (Form W-5) with their employer, who calculates and administers the credit. Employers report the AEIC payments in Box 9 of an employee's Wage and Tax Statement (Form W-2). These taxpayers are required to file a Federal tax return and report the AEIC payments as additional tax, which is offset by the EITC they may be entitled to receive.

The IRS processed over 297,000 TY 2000 and 2001 individual income tax returns with AEIC payments totaling approximately \$140 million during Calendar Years 2001 and 2002. Our analysis of tax account data for these 2 tax years determined that the IRS did not have reasonable assurance that an estimated 22 percent of the returns with reported AEIC payments were processed correctly in each tax year. This represents

¹ Revenue Act of 1978, Pub. L. No. 95-600.

² The Congress established the EITC in 1975 to provide a refundable credit to low-income taxpayers, to offset the impact of Social Security taxes and increases in cost of living expenses and to encourage them to seek employment rather than welfare. The IRS administers the credit through a reduction in the amount of tax owed, if any, on the individual tax return. The credit amount in excess of the amount of tax owed could be refunded to the taxpayer. (Tax Reduction Act – Title I: Refund of 1974 Individual Income Taxes, Pub. L. No. 94-12.)

³ Maximum amount of EITC an employer can give a taxpayer throughout 2001.

approximately 65,000⁴ taxpayers who may have been erroneously assessed \$26 million in tax for AEIC payments they did not receive.

We analyzed a judgmental sample⁵ of 278 tax accounts with AEIC amounts greater than \$4,008⁶ in TY 2001 to determine the accuracy of the \$3.1 million in AEIC payment amounts captured by IRS employees on the IRS computer system during tax return processing. For 274 (99 percent) accounts, over \$3 million in AEIC payments were incorrect because either IRS employees transcribed an incorrect AEIC payment amount or taxpayers incorrectly reported the amount on their tax returns, causing erroneous assessments to some accounts. These 274 accounts showed the following:

- For 35 (13 percent) accounts – taxpayers unnecessarily paid all or a portion of the erroneous assessments, made arrangements to pay, or were wrongly placed in the collection process by the IRS.
- For 153 (56 percent) accounts – corrections were made as a result of actions initiated by 106 taxpayers after the IRS notified them of the additional tax assessment, or by the IRS prior to assessing 47 taxpayers.
- For 86 (31 percent) accounts – taxpayers reported another type of tax on the AEIC payment line; however, the error did not change the amount of the tax assessed.

Verification of information input to computer systems helps ensure the data captured are accurate and complete and serves as a defense to prevent and detect errors. The IRS does not have procedures in place during processing to ensure that AEIC payments are correctly captured from tax returns not reporting the EITC.⁷ The IRS does not key verify the AEIC payment information or require employees to compare it to Box 9 of the Form W-2 for accuracy.

We recommended the Commissioner, Wage and Investment Division, establish procedures to ensure the reported AEIC payment amounts are reconciled with the Form W-2 amounts and correctly input during processing of individual income tax returns.

Management's Response: IRS management agreed with the recommendation and has already begun corrective actions. Specifically, IRS management has updated the instructions for the Code and Edit function to require tax examiners to compare the amount of AEIC shown on the tax return to the amount listed as AEIC in Box 9 of the Form W-2 and adjust the amount when needed. They have also submitted requests for programming changes to create an error condition:

⁴ None of these taxpayers received the EITC, which is an indication that these taxpayers were less likely to have received the AEIC.

⁵ We used a judgmental sample due to time and resource constraints (see Appendix I).

⁶ The maximum amount of EITC a taxpayer may claim on his or her 2001 tax return based on adjusted gross income and the number of EITC-qualifying children.

⁷ When the EITC is present on the tax return, the IRS verifies the accuracy of the amount of the AEIC payment reported by the taxpayer by comparing the reported amount to Box 9 of the Form W-2.

- (a) When the amount of AEIC claimed exceeds the maximum yearly allowance (\$1,528 effective for processing year 2004).
- (b) Any time the AEIC is listed without a corresponding entry for the EITC (effective for implementation in January 2005).

While IRS management agreed with our actual benefits as described in Appendix IV, they did not agree with the potential benefits of \$26 million in tax for 65,000 taxpayers. The IRS believes that our calculations do not take into consideration the fact that over 31 percent of the errors had no effect on the taxpayer's liability, 17 percent were corrected in processing, and 39 percent were corrected in post-processing. In addition, 40 percent of the returns we reviewed indicated that taxpayer error had caused the incorrect entry. While these errors would still require correction, implementing our recommendation would not reduce this cost. As a result, the IRS believes that our benefit analysis should be reduced to reflect these points. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: We cannot make projections from results of a sample that has not been statistically selected. In addition, we cannot transpose these results to a separate noncongruent population. The IRS response referred to our testing of a judgmental sample of 278 tax accounts with AEIC amounts greater than \$4,008 in TY 2001. This analysis was to determine the accuracy of the \$3.1 million in AEIC payments captured for these accounts by IRS employees on the IRS computer system during processing. We found that the IRS corrected 47 (17 percent) of the tax accounts prior to assessing the taxpayers and corrected 106 (39 percent) of the tax accounts as the result of actions initiated by the taxpayers. In 86 (31 percent) of the tax accounts, the error did not change the amount of the tax assessed. In a separate test of 60 original returns, 38 percent of the returns reviewed indicated taxpayer error as the cause of the incorrect entry.

In a separate independent test, we identified approximately 65,000 (22 percent of taxpayers claiming the AEIC for TYs 2000 and 2001) taxpayers who claimed the AEIC but no EITC, and who may have been erroneously assessed \$26 million in tax for AEIC payments they did not receive. Without controls to identify returns claiming the AEIC but no EITC, the IRS does not have reasonable assurance that these returns would be processed correctly.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-7085.

**Taxpayers Were Assessed Additional Tax for
Advance Earned Income Credit Payments Not Received**

Table of Contents

Background	Page 1
The Internal Revenue Service Did Not Have Reasonable Assurance That Advance Earned Income Credit Payments Were Processed Correctly.....	Page 3
<u>Recommendation 1:</u>	Page 10
Appendix I – Detailed Objective, Scope, and Methodology	Page 12
Appendix II – Major Contributors to This Report.....	Page 14
Appendix III – Report Distribution List	Page 15
Appendix IV – Outcome Measures	Page 16
Appendix V – Management’s Response to the Draft Report	Page 18

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

Background

In 1975, the Congress authorized¹ the Secretary of the Treasury to amend the Internal Revenue Code to provide a credit to taxpayers with certain earned income. This refundable credit, known as the Earned Income Tax Credit (EITC), was established to offset the impact of Social Security taxes and increases in cost of living expenses on low-income families and to encourage them to seek employment rather than welfare.

The Internal Revenue Service (IRS) administers the credit through a reduction in the amount of tax owed, if any, on the individual tax return. The credit amount in excess of the amount of tax owed could be refunded to the taxpayer.

The Congress established the Advance Earned Income Credit (AEIC) in 1978² to allow eligible employees who (1) have at least one qualifying child, (2) fall within certain income limits, and (3) expect to claim the EITC on their tax return to receive part of the EITC in advance with their pay during the year. During Tax Year (TY) 2001, employees could receive up to \$1,457³ in AEIC.

Employees who choose to receive the AEIC file an Earned Income Credit Advance Payment Certificate (Form W-5) with their employer, who calculates and administers the credit. The Form W-5 remains in effect until the end of the calendar year unless the employee revokes it or files another Form W-5.

Employers report the AEIC payments in Box 9 of an employee's Wage and Tax Statement (Form W-2). Taxpayers who receive AEIC payments are automatically required to file a Federal tax return and report the AEIC payments as additional tax, which is used to offset the EITC they may be entitled to receive.

While the volume of individual income tax returns processed with the EITC remained constant at approximately 19 million between TY 1999 and TY 2001,

¹ Tax Reduction Act – Title I: Refund of 1974 Individual Income Taxes, Pub. L. No. 94-12.

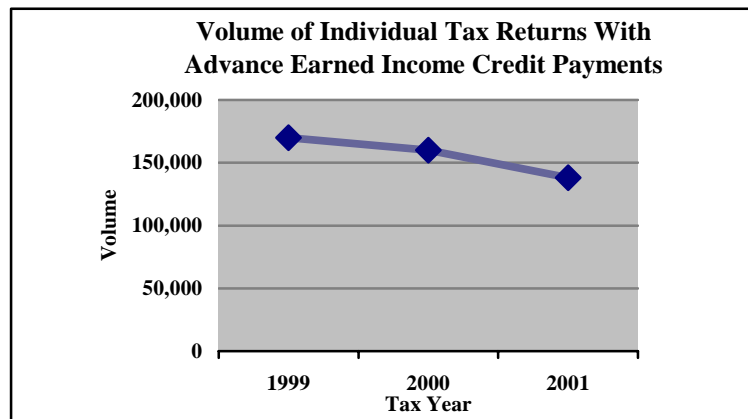
² Revenue Act of 1978, Pub. L. No. 95-600.

³ Maximum amount of EITC an employer can give a taxpayer throughout 2001.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

Figure 1 below shows that the volume of the tax returns processed with AEIC payments declined during these periods from 169,000 to 138,000.

Figure 1



Source: The IRS' Return Transaction File for Tax Years 1999 – 2001.

The amount of AEIC payments reported by taxpayers also declined from \$81 million to \$67 million for the same period, contrary to the increase in EITC claims processed from \$31 billion to \$32.5 billion. Overall, less than 1 percent of the taxpayers who receive the EITC choose to receive the AEIC to offset the increases in their living expenses and Social Security taxes during the year.

The audit was conducted in the IRS National Headquarters in New Carrollton, Maryland; the Wage and Investment (W&I) Division Headquarters in Atlanta, Georgia; and the Atlanta Submission Processing Site between November 2002 and February 2003. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

The Internal Revenue Service Did Not Have Reasonable Assurance That Advance Earned Income Credit Payments Were Processed Correctly

The IRS processed over 297,000 TY 2000 and 2001 individual income tax returns with AEIC payments totaling approximately \$140 million during Calendar Years 2001 and 2002. Our analysis of tax account data for these 2 tax years determined that the IRS did not have reasonable assurance that an estimated 22 percent of the returns with reported AEIC payments were processed correctly in each tax year. This represents approximately 65,000⁴ taxpayers who may have been erroneously assessed \$26 million in tax for AEIC payments they did not receive.

We analyzed a judgmental sample of 278 tax accounts with AEIC amounts greater than \$4,008⁵ in TY 2001 to determine the accuracy of the \$3.1 million in AEIC payments captured for these accounts by IRS employees on the IRS computer system during tax return processing. We researched the IRS' computer systems for tax account information showing tax adjustments to the accounts as a result of AEIC payment errors. For 274 (99 percent) accounts, over \$3 million in AEIC payments captured were incorrect because either IRS employees erroneously transcribed the AEIC payment amounts or taxpayers reported a wrong amount on the AEIC payment line on their tax returns, causing erroneous assessments to some accounts. These 274 accounts showed the following:

- For 35 (13 percent) accounts – taxpayers unnecessarily paid all or a portion of the erroneous assessments, made arrangements to pay, or were wrongly placed in the collection process by the IRS.
- For 153 (56 percent) accounts – corrections were made as a result of actions initiated by 106 taxpayers after the IRS notified them of the additional tax assessment, or by the IRS prior to assessing 47 taxpayers.

⁴ None of these taxpayers received the EITC, which is an indication that these taxpayers were less likely to have received the AEIC.

⁵ The maximum amount of EITC a taxpayer may claim on his or her 2001 tax return based on adjusted gross income and the number of EITC-qualifying children.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

- For 86 (31 percent) accounts – taxpayers reported another type of tax on the AEIC payment line; however, the error did not change the amount of the tax assessed.

The more specific details of the impact of the errors on the 274 taxpayers are provided below.

Taxpayers paid the erroneous tax assessments, made arrangements to pay, or were placed in the IRS' collection process

In total, 35 taxpayers paid all or a portion of the erroneous assessments, made arrangements to pay, or were placed by the IRS in the collection process with accounts totaling over \$267,000 in erroneous AEIC payment amounts. Tax account information indicated that the taxes paid or owed by these taxpayers equaled or closely matched the AEIC payment amounts.

- For 14 taxpayers, the IRS assessed and collected over \$121,000 in taxes not actually owed. Examples included incorrectly reporting wages as AEIC payments and incorrectly reporting dependent care benefits⁶ as AEIC, resulting in the payment of additional tax that was not due.
- For 5 taxpayers, the IRS secured payment agreements for over \$26,000 from erroneous tax assessments.
- For the remaining 16 taxpayers, the IRS assessed over \$120,000 in taxes that were subsequently placed into the IRS collection process based on AEIC payments never received by the taxpayers.

We provided IRS management with information on these 35 taxpayers during the audit. They plan to further review the related tax accounts and take appropriate action.

⁶ Dependent care benefits are generally reported on page 2 of the Credit for Child and Dependent Care Expenses (Form 2441) and are used in calculating the taxpayer's allowable amount of Child Care Credit, which generally reduces the total tax.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

The IRS corrected the errors after taxpayers requested tax abatements

For 106 accounts, the IRS had to correct approximately \$1 million of the transcribed payments after taxpayers responded to IRS notices of a change in the amount of tax that was assessed. These accounts showed that after the notices were sent, the IRS abated the tax. The abatement equaled the AEIC payment or there was an indication on the account that the abatement included the erroneous AEIC payment.

Refunds for 91 of these taxpayers were delayed from 2 to 26 weeks. The average delay was 3 weeks. The IRS paid over \$600 in interest, ranging from \$2.62 to \$153.03, to 18 of these taxpayers.

The IRS corrected the errors prior to the assessment

For 47 accounts, the IRS identified errors and corrected them during processing when the tax return was selected for error correction for another reason or during sample reviews of a few select notices to the taxpayers prior to issuance.

AEIC payment errors did not change the amount of taxes assessed

For 86 accounts, the taxpayer reported another type of tax on the AEIC payment line on the tax return or the IRS incorrectly transcribed “other tax” amounts as AEIC payments. These errors did not change the amount of the taxes assessed. The most common error was the tax on qualified plans, from line 55 of the United States Individual Income Tax Return (Form 1040). This line is directly above the AEIC payment line on the form.

A verification process can help prevent and detect errors

Verification of information input to computer systems helps ensure the data captured are accurate and complete and serves as a defense to prevent and detect errors. The IRS does not have procedures in place during processing to ensure that AEIC payments are correctly captured from tax

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

returns not reporting the EITC.⁷ The IRS requires employees to neither compare the AEIC payment amount reported on the tax return (for example, line 56 on Form 1040) to Box 9 of the Form W-2 nor to key verify the AEIC payment amount for accuracy. Figures 2 and 3 below show the areas of each form discussed.

Figure 2
Form W-2, Advance EIC Box

The image shows a Form W-2 Wage and Tax Statement for the year 2001. The form is divided into several sections. Box 9, labeled 'Advance EIC payment', is highlighted with a black arrow pointing to it from a text box below the form that reads 'Form W-2, Box 9, AEIC Payment Amount'. The form includes fields for contact number, employer identification number, employee's name and address, employee's social security number, and employee's first name and initial. It also includes fields for wages, tips, other compensation, federal income tax withheld, social security wages, social security tax withheld, Medicare wages and tips, Medicare tax withheld, social security tips, allocated tips, advance EIC payment, dependent care benefits, qualified plans, and other benefits. The form is dated 2001 and includes the text 'W-2 Wage and Tax Statement' and '2001'.

Source: Internal Revenue Service Tax Forms for Individual Taxpayers.

⁷ When the EITC is present on the tax return and the AEIC line is blank, IRS employees will review Forms W-2 to determine if the taxpayer had received any AEIC.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

Figure 3

Form 1040, Advance Earned Income Credit Line

Tax and Credits

34 Amount from line 33 (adjusted gross income) 34

35a Check if: ☐ You were 65 or older, ☐ Blind, ☐ Spouse was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here. 35a

35b If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 31 and check here. 35b

36 Itemized deductions (from Schedule A) or your standard deduction (see left margin) 36

37 Subtract line 36 from line 34 37

38 If line 34 is \$99,725 or less, multiply \$2,900 by the total number of exemptions claimed on line 6d. If line 34 is over \$99,725, see the worksheet on page 32 38

39 Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0- 39

40 Tax (see page 33). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972 40

41 Alternative minimum tax (see page 34). Attach Form 6251 41

42 Add lines 40 and 41 42

43 Foreign tax credit. Attach Form 1116 if required 43

44 Credit for child and dependent care expenses. Attach Form 2441 44

45 Credit for the elderly or the disabled. Attach Schedule R 45

46 Education credits. Attach Form 8863 46

47 Rate reduction credit. See the worksheet on page 36 47

48 Child tax credit (see page 37) 48

49 Adoption credit. Attach Form 8839 49

50 Other credits from: a ☐ Form 3800 b ☐ Form 8396 c ☐ Form 8801 d ☐ Form (specify) 50

51 Add lines 43 through 50. These are your total credits 51

52 Subtract line 51 from line 42. If line 51 is more than line 42, enter -0- 52

Other Taxes

53 Self-employment tax. Attach Schedule SE 53

54 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137 54

55 Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required 55

56 Advance earned income credit payments from Form(s) W-2 56

57 Household employment taxes. Attach Schedule H 57

58 Add lines 52 through 57. This is your total tax 58

Source: Internal Revenue Service Tax Forms for Individual Taxpayers.

Form 1040,
Page 2,
Line 56,
AEIC Payment

We reviewed the tax returns for 60 of the 278 tax accounts in our sample and determined that IRS employees incorrectly transcribed the AEIC payment amounts for 36 (60 percent) tax accounts, totaling over \$786,000. The taxpayer incorrectly reported the AEIC payment amount on 23 (38 percent), totaling over \$576,000. Generally, either Box 9 of the Form W-2 did not show an AEIC payment amount or the taxpayer did not report Form W-2 income on the tax return. Both were good indications that the AEIC payment amounts were incorrect.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

Trends indicated the AEIC errors were widespread

We conducted additional analysis of the 31,400⁸ TY 2001 accounts processed with AEIC payments to identify trends that indicated the AEIC payment errors were widespread. The analysis identified the following trends⁹ that make the AEIC payment amounts that were processed highly questionable. In our opinion, taxpayers who qualify for the AEIC would not likely have these transactions normally occurring to their accounts:

- 9,013 (29 percent) accounts had \$15.3 million in unpaid taxes due the IRS – \$7.1 million in AEIC payments.
- 7,043 (22 percent) accounts had Adjusted Gross Income¹⁰ (AGI) between \$32,122¹¹ and \$50,000 – \$3 million in AEIC payments.
- 5,807 (18 percent) accounts had AGI over \$50,000 – \$4.6 million in AEIC payments.
- 2,222 (7 percent) accounts were corrected by the IRS – \$2.6 million in AEIC payments.
- 1,232 (4 percent) accounts had AEIC payments greater than \$1,457 – \$5.8 million in AEIC payments.
- 719 (2 percent) accounts had estimated tax payments¹² totaling \$14.5 million – \$1.3 million in AEIC payments.
- 550 (2 percent) accounts did not report wages – \$725,000 in AEIC payments.

⁸ Represents the TY 2001 accounts among the 65,000 TY 2000 and 2001 accounts that were processed with the AEIC even though the taxpayers did not receive the EITC.

⁹ Some accounts fall into more than one category.

¹⁰ Income (including wages, interest, capital gains, income from retirement accounts, alimony paid to you) adjusted downward by certain adjustments on the tax return (including contributions to deductible retirement accounts, alimony paid by the taxpayer).

¹¹ The maximum amount of AGI before the EITC is phased out.

¹² Estimated tax payments are payments used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

- 52 (.2 percent) accounts had reported wages that were less than the AEIC amount – \$668,000 in AEIC payments.

The IRS also compiles data on certain income and tax items on selected tax return series, such as Forms 1040, 1040A, and 1040 EZ. We reviewed these reports for TYs 1999 – 2001. The statistics captured on AEIC volumes and payment amounts showed that, each year, the IRS processed tax returns with the AEIC where the AGI amount reported was over \$1 million, another strong indication that the AEIC payment amounts on these tax returns were incorrect and that the errors continued to occur each year. Excerpts taken from the reports and provided in Figure 4 below show a breakdown by AGI categories from \$100,000 and over for AEIC volumes and payment amounts processed during these periods.

Figure 4

Analysis of AEIC Reported on Individual Income Tax Returns With Adjusted Gross Income (AGI) \$100,000 or More					
	AGI 100,000 Under 150,000	AGI 150,000 Under 200,000	AGI 200,000 Under 500,000	AGI 500,000 Under 1 Million	AGI 1 Million and Over
Tax Year 1999					
Volume	673	153	116	15	29
Amount (in \$000's)	\$482	\$109	\$163	\$37	\$1,183
Tax Year 2000					
Volume	736	186	168	36	27
Amount (in \$000's)	\$540	\$190	\$284	\$37	\$2,030
Tax Year 2001					
Volume	717	188	145	28	15
Amount (in \$000's)	\$593	\$180	\$362	\$41	\$1,193

Source: U.S. Selected Income and Tax Items 1040, 1040A, & 1040EZ Report.

**Taxpayers Were Assessed Additional Tax for
Advance Earned Income Credit Payments Not Received**

Recommendation

1. We recommend the Commissioner, W&I Division, establish procedures to ensure the reported AEIC payment amounts are reconciled with the Form W-2 amounts and correctly input during processing of individual income tax returns.

Management's Response: IRS management agreed with the recommendation and has already begun corrective actions. Specifically, IRS management has updated the instructions for the Code and Edit function to require tax examiners to compare the amount of AEIC shown on the tax return to the amount listed as AEIC in Box 9 of the Form W-2 and adjust the amount when needed. They have also submitted requests for programming changes to create an error condition:

- (a) When the amount of AEIC claimed exceeds the maximum yearly allowance (\$1,528 effective for processing year 2004).
- (b) Any time the AEIC is listed without a corresponding entry for the EITC (effective for implementation in January 2005).

While IRS management agreed with our actual benefits as described in Appendix IV, they did not agree with the potential benefits of \$26 million in tax for 65,000 taxpayers. The IRS believes that our calculations do not take into consideration the fact that over 31 percent of the errors had no effect on the taxpayer's liability, 17 percent were corrected in processing, and 39 percent were corrected in post-processing. In addition, 40 percent of the returns we reviewed indicated that taxpayer error had caused the incorrect entry. While these errors would still require correction, implementing our recommendation would not reduce this cost. As a result, the IRS believes that our benefit analysis should be reduced to reflect these points.

Office of Audit Comment: We cannot make projections from results of a sample that has not been statistically selected. In addition, we cannot transpose these results to a separate noncongruent population.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

The IRS response referred to our testing of a judgmental sample of 278 tax accounts with AEIC amounts greater than \$4,008 in TY 2001. This analysis was to determine the accuracy of the \$3.1 million in AEIC payments captured for these accounts by IRS employees on the IRS computer system during processing. We found that the IRS corrected 47 (17 percent) of the tax accounts prior to assessing the taxpayers and corrected 106 (39 percent) of the tax accounts as the result of actions initiated by the taxpayers. In 86 (31 percent) of the tax accounts, the error did not change the amount of the tax assessed. In a separate test of 60 original returns, 38 percent of the returns reviewed indicated taxpayer error as the cause of the incorrect entry.

In a separate independent test, we identified approximately 65,000 (22 percent of taxpayers claiming the AEIC for TYs 2000 and 2001) taxpayers who claimed the AEIC and no EITC and who may have been erroneously assessed \$26 million in tax for AEIC payments they did not receive. Without controls to identify returns claiming the AEIC and no EITC, the IRS does not have reasonable assurance that these returns would be processed correctly.

**Taxpayers Were Assessed Additional Tax for
Advance Earned Income Credit Payments Not Received**

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine if the Internal Revenue Service (IRS) had reasonable assurance during tax return processing that the Advance Earned Income Credit (AEIC) payments reported by taxpayers were correct. To accomplish our objective, we:

- I. Determined if the IRS is accurately capturing the AEIC payment amount during the processing of the tax returns.
 - A. Extracted electronic records for 136,578 Tax Year (TY) 2001 tax returns identified with AEIC payments from the 2002 Return Transaction File (RTF) as of October 2002. The data were obtained from the Treasury Inspector General for Tax Administration's Data Warehouse, which compiles and stores electronic data from various IRS computer systems.
 - B. Selected a judgmental sample¹ of 80 of 278 TY 2001 tax returns identified with AEIC payments greater than \$4,008 and requested the original tax returns.
 - C. Obtained and reviewed 60 original tax returns and compared the AEIC payment amount transcribed during processing to the amount shown on the corresponding tax return and Wage and Tax Statement (Form W-2) for accuracy, to determine the cause of any discrepancies.
- II. Determined the number of taxpayers that had tax liabilities overstated due to incorrect AEIC payment amounts captured during processing of TY 2000 and 2001 tax returns.
 - A. Obtained TY 2000 and 2001 electronic records of tax returns processed by the IRS through December 2001 and 2002, respectively, from the RTF. Stratified the AEIC payments on these tax returns by using the following maximum allowable Earned Income Tax Credit (EITC) amounts applicable to the number of EITC-qualifying children the taxpayer reported:
 1. No qualifying child and EITC > \$353 for TY 2000; > \$364 for TY 2001.
 2. One qualifying child and EITC > \$2,355 for TY 2000; > \$2,428 for TY 2001.
 3. More than 1 qualifying child and EITC > \$3,888 for TY 2000; > \$4,008 for TY 2001.
 4. Any AEIC payment amount with AEIC > \$1,412 for TY 2000; > \$1,457 for TY 2001.

¹ We used a judgmental sample due to time and resource constraints.

**Taxpayers Were Assessed Additional Tax for
Advance Earned Income Credit Payments Not Received**

- B. Calculated the number of returns for each category and the total amount of AEIC payments that exceeded the allowable amount of the EITC for the particular category.
 - C. Analyzed TY 2001 electronic records for trends that indicated the AEIC errors were widespread, based on the results of our review of the 278 tax accounts in our sample in Step III. below.
- III. Determined what actions the IRS took, if any, to resolve accounts where the incorrect amounts of AEIC payments were processed. For the initial 278 TY 2001 tax returns in Step I.B. above, analyzed the tax account information requested and reviewed the related Integrated Data Retrieval System² tax account information to determine the number of tax returns and related AEIC payment amounts for the following categories:
- A. Proper adjustments were made to the taxpayer's account to correct the AEIC payment error.
 - B. Unresolved account was assigned to other post-processing functions as the direct or indirect result of an incorrect AEIC payment amount.
 - C. Taxpayer's account was in balance due status due to the AEIC payment error.
 - D. Taxpayer's account was in fully paid status, and no action was taken to resolve the error.
- IV. Using the RTF tax account data for TY 2001, requested Master File³ tax account data and identified trends indicating AEIC payment errors were widespread.

² IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

³ The IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

**Taxpayers Were Assessed Additional Tax for
Advance Earned Income Credit Payments Not Received**

Appendix II

Major Contributors to This Report

Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Gary L. Young, Acting Director
Patricia Lee, Audit Manager
Anthony Anneski, Acting Audit Manager
Lynn Faulkner, Senior Auditor
Jack Forbus, Senior Auditor
Alan Lund, Senior Auditor
Jerome Antoine, Auditor
Jean Bell, Auditor
Andrea McDuffie, Auditor
Dorothy Richter, Computer Specialist
Jeffrey Williams, Computer Specialist

**Taxpayers Were Assessed Additional Tax for
Advance Earned Income Credit Payments Not Received**

Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner for Services and Enforcement N:DC
Commissioner, Small Business/Self-Employed Division S
Deputy Commissioner, Small Business/Self-Employed Division S
Deputy Commissioner, Wage and Investment Division W
Director, Compliance W:CP
Director, Customer Account Services W:CAS
Director, Strategy and Finance W:S
Director, Submission Processing W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M
Audit Liaisons:
 Program/Process Assistant Coordinator, Wage and Investment Division W:HR
 Chief, Customer Liaison S:COM

**Taxpayers Were Assessed Additional Tax for
Advance Earned Income Credit Payments Not Received**

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Actual; nearly \$267,000 in tax that should be abated for 35 taxpayers due to the incorrect tax assessments caused by Advance Earned Income Credit (AEIC) payment errors (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained tax return data from the Tax Year (TY) 2000 and 2001 Return Transaction Files¹ (RTF) for the approximately 297,000 TY 2000 and 2001 tax returns with AEIC payment amounts captured by the Internal Revenue Service (IRS) during processing of the tax returns. We analyzed the electronic data and identified 65,000 tax returns with \$26 million in AEIC payments and no Earned Income Tax Credit (EITC). We also identified a total of 278 tax returns with AEIC payments greater than \$4,008.² We researched various IRS computer systems for information on the tax accounts that showed the taxpayers paid all or a portion of the erroneous tax assessment, made arrangements to pay, or were placed in the collection process. We identified 35 of the 278 tax accounts meeting these criteria. Information on these accounts indicated that the tax collected or owed by the taxpayers equaled or closely matched the AEIC payment amounts and that the payment amounts were incorrect. We determined that these 35 accounts totaled nearly \$267,000 in erroneous AEIC payments.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; approximately \$26 million in tax, for 65,000 taxpayers, that may have been incorrectly assessed on AEIC payments the taxpayers did not receive (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained tax return data from the TY 2000 and 2001 RTFs for the approximately 297,000 TY 2000 and 2001 tax returns with AEIC payment amounts captured during processing of the tax returns. We analyzed the electronic data and identified 65,000 tax returns with \$26 million in AEIC payments and no EITC. Based on the inadequate IRS controls during

¹ Electronic records of tax return information captured on paper and electronically filed tax returns.

² The maximum amount of EITC a taxpayer may claim on his or her 2001 tax return based on adjusted gross income and the number of EITC-qualifying children.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

processing to reasonably assure the AEIC payment amounts were correct, the IRS is at risk of incorrectly assessing the tax on the AEIC payments processed for these returns.

Type and Value of Outcome Measure:

- Reduction of Burden on Taxpayers – Actual; 106 taxpayers affected (see page 3).

Methodology Used to Measure the Reported Benefit:

For the 278 TY 2001 tax returns in our sample with AEIC payments greater than \$4,008, we researched the IRS' computer systems for tax account information showing tax adjustments to the accounts as a result of AEIC payment errors. We identified 106 of 278 tax accounts where abatements of tax were made after taxpayers responded to IRS notices of an increase in tax assessed due to errors in AEIC payment amounts. The abatement equaled the AEIC payment, or there was an indication on the account that the abatement included the erroneous AEIC payment.

**Taxpayers Were Assessed Additional Tax for
Advance Earned Income Credit Payments Not Received**

Appendix V

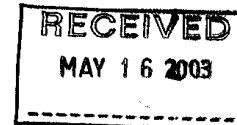
Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

MAY 16 2003



MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM:

John M. Dalrymple
John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT:

Draft Audit Report – Taxpayers Were Erroneously Assessed
Additional Tax for Advanced Earned Income Credit Payments
Not Received (Audit No. 200340028)

I reviewed your report and agree that we could improve processing procedures to correct taxpayer and transcription errors of Advanced Earned Income Credits (AEIC). I believe that you appropriately recognized the small number of taxpayers affected by these errors and our overall success in correcting them. As your report notes, 17 percent of the errors were corrected during processing, 31 percent had no tax impact, and 39 percent were corrected as a result of taxpayer inquiries. I agree taxpayers who contacted us to resolve the errors experienced some burden. Your observation that most of the errors resulted from the proximity of the entry lines for "Other Taxes" with the entry lines for AEIC on Form 1040 is also correct.

We are reviewing the taxpayer accounts that your report identified as paid, making installment payments, or in collection status to determine if the tax was the result of an incorrect AEIC entry. When verified, we will promptly correct these accounts and refund any overpayment. Thank you for providing the identifying information of those taxpayers.

I agree with the actual benefits listed in the report. However, I disagree with the potential benefits stated as Taxpayer Rights and Entitlements of \$26 million in tax for 65,000 taxpayers. Your calculation does not consider the fact that over 31 percent of the errors had no effect on the taxpayers' tax liability, 17 percent were corrected in processing, and 39 percent in post-processing. In addition, 40 percent of the returns that you reviewed indicated taxpayer error as the cause of the incorrect entry. Of course, these incorrect entries would still require correction. Implementing the

**Taxpayers Were Assessed Additional Tax for
Advance Earned Income Credit Payments Not Received**

2

recommendation would not reduce this cost. Your benefit analysis should be reduced to reflect these considerations.

If you have any questions, please call me or Ronald S. Rhodes, Director, Customer Account Services, at (404) 338-8910.

Attachment

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received

Attachment

RECOMMENDATION

We recommend that the Commissioner, Wage and Investment Division, consider establishing procedures to ensure reported AEIC payment amounts are reconciled with the Form W-2 and correctly input during processing of individual income tax returns.

CORRECTIVE ACTION

We agree with this recommendation and initiated the following actions:

1. Updated the Internal Revenue Manual instructions for Code and Edit function to require tax examiners to compare the amounts of AEIC shown on the tax return to the amount listed as AEIC in Box 9 of the W-2 and adjust the amount when needed.
2. Submitted a Request for Information Services (RIS) on March 27, 2003, to request programming to create an error condition when the amount of AEIC claimed exceeds the maximum yearly allowance. The RIS WSP-3-0096-A01 will establish a maximum AEIC of \$1,528.00 for processing year 2004.
3. Submitted a placeholder RIS to create an error condition anytime AEIC is listed without a corresponding entry for Earned Income Credit. We will submit the RIS in October 2003, and perfect it as necessary, to meet the final RIS due date of February 28, 2004, for implementation in January 2005.

IMPLEMENTATION DATE

1. Completed - April 15, 2003
2. Scheduled for Implementation - January 15, 2004
3. Scheduled for Implementation - January 17, 2005

RESPONSIBLE OFFICIALS

Director, Submission Processing
Director, Customer Account Services

CORRECTIVE ACTION MONITORING PLAN

Implementation of these corrective actions will be monitored through our internal control system and managerial oversight. Delays in implementation will be reported to appropriate executives. Completing these corrective actions will identify the incorrect AEIC entries and allow us to review and correct them during processing.